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DIRECTORATE OF INTELLIGENCE

MEMORANDUM FOR: Douglas Newkirk
Assistant United States Trade Representative

FROM: [redacted] 25X1
Acting Chief, Economics Division
Office of Global Issues

SUBJECT: China's Accession to the GATT and the Supply of Trade-Related Economic Data [redacted] 25X1

The attached memorandum responds to your request for a look at what types of information would be needed to evaluate Chinese trade policies from the perspective of satisfying GATT tenets. The memorandum identifies several basic information categories, including production costs, government procurement prices, and domestic sales prices. We believe the Chinese would be reluctant to provide this information but could be persuaded to do so by the benefits associated with GATT membership. Your comments may be addressed to the Acting Chief, Economics Division, Office of Global Issues, [redacted] 25X1

[redacted] 25X1

Attachment:
<u>China's Accession to the GATT and the Supply of Trade-Related Economic Data</u>, [redacted] 25X1
GI M 85-10321 [redacted] 25X1

[redacted] 25X1

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SUBJECT: China's Accession to the GATT and the
Supply of Trade-Related Economic Data [redacted] 25X1

OGI/ECD/DI [redacted] (12 Dec 85) 25X1

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DIRECTORATE OF INTELLIGENCE

12 December 1985

China's Accession to the GATT and the Supply of Trade-Related Economic Data

Summary

During the past year China has shown considerable interest in obtaining full membership in the GATT, and has recently offered to reduce its tariffs as a condition for its entry. Because the central government continues to have a major impact on trade through its control of domestic prices, subsidies, and taxes, the GATT will need to receive new information from China on a periodic basis in order to evaluate the role of China's tariffs and to monitor China's compliance with the basic tenets of the GATT. Given these circumstances, present GATT members, as a condition for China's admission, might require China to provide international trade-related economic data, to ensure China is not, through its centralized trading system, taking inappropriate advantage of GATT membership. Important information to be monitored in such a program would include:

- Government procurement prices and domestic sales prices for export goods.
- Wages and other costs of production for export goods.
- The level of direct government subsidies and other financial incentives to enterprises engaging in foreign trade.
- Tariff rates and revenues for import goods.
- Domestic sales and foreign procurement prices for import goods.
- Shares of trade conducted by government trade corporations and financially independent corporations, for each traded commodity.

We anticipate that the Chinese initially will be reluctant to accept any commitment to the GATT to supply economic data, but in the end could be persuaded that this was in their self-interest. [redacted] 25X1

This memorandum was prepared by [redacted] the Economics Division of the Office of Global Issues, in response to a request from the Office of the Special Trade Representative. Questions and comments are welcome and may be directed to the Acting Chief, Economics Division, [redacted] 25X1 25X1

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China's Accession to the GATT and the Supply of Trade-Related Economic Data

China's Evolving Foreign Trade System

Until 1979, all foreign trade was conducted by the state-controlled Foreign Trade Corporations (FTCs) according to annual plans that were drafted by the State Planning and Economic Commissions. At present, however, we estimate that only about 60 percent of China's total trade is conducted by the FTCs under the dictates of the central plan while the remaining 40 percent is conducted by enterprises that are responsible for their own profits and losses. Even these financially independent enterprises, however, are tightly constrained by the state. 25X1

In this mixed system, China's foreign trade plans -- defined in physical terms -- are established through an iterative process of balancing the material needs and availabilities of the domestic economy, while simultaneously maintaining the desired balance between foreign exchange earnings and expenditures. In deciding what to trade, the state planners generally ignore financial profits and losses on foreign trade calculated in the domestic Chinese currency (the RMB Yuan), because domestic prices are acknowledged to be artificial and usually distorted. 25X1

FTCs procure export goods at the domestic prices, which are set by the State Price Commission, and convert foreign exchange earnings from their sale abroad into yuan at the artificial exchange rate set by the People's Bank of China. FTCs may either gain or lose yuan on individual transactions, depending, respectively, on whether the yuan value of the foreign sale is greater or less than the domestic procurement cost. 25X1

Similarly, on imported commodities such as wheat, corn, cotton, and fertilizers, for which there are domestically-produced equivalents, FTCs must sell the imported goods in the domestic market at the same prices as those set for the domestically-produced goods. The proceeds from those sales may differ greatly

from the yuan value of the foreign exchange used to procure the goods, so that FTCs again may either gain or lose yuan on an individual transaction.* At the end of each accounting period, the gains and losses are consolidated and the net surplus or deficit is then, respectively, taxed away or subsidized directly by the Ministry of Finance. [redacted] 25X1

These accounting profits and losses made little difference when trade was monopolized by the central government. As the foreign trade system has become more decentralized, however, what once had been merely "paper" profits and losses became quite "real" to financially independent enterprises, leading to a trade pattern that probably was contrary to China's comparative advantage. At the official exchange rate of 3.0 yuan per dollar, domestic prices for primary products generally appear to be lower than world prices, while those for manufactures appear to be higher. Hence, on paper, it is generally profitable for Chinese traders to export primary products and to import manufactures. The reverse -- exporting manufactures and importing primary products -- tends to produce losses. As financially independent enterprises became more involved in trade, this distorted price structure encouraged exports of capital- and land-intensive commodities that were in short supply (e.g., oil, steel, and tobacco) as well as imports of labor-intensive manufactures that could have been produced for a lower real cost at home (e.g., cameras, televisions, radios, and wristwatches). [redacted] 25X1

In order to adjust for these effects Beijing has introduced a trade licensing system and considerably revised its tariff system. The licensing system gives the

* On imports for which there are no domestically-produced equivalents, the FTCs use a cost-plus pricing method -- which includes tariffs, freight, insurance, and the FTC's handling fees -- so there can be no domestic currency loss. Until the early 1980s, about 80 percent of China's imports were priced using the usual, domestic equivalent method. Since then, however, we suspect that use of the cost-plus pricing method has increased as a result of an increase in one-of-a-kind machinery imports.

Ministry of Foreign Economic Relations and Trade (MFERT) new regulatory capabilities to prevent local enterprises from exporting goods in short supply or from importing goods that compete with domestic products. The new tariffs are designed to compensate for distorted domestic prices by increasing the costs of exporting primary products and importing certain manufactures. [redacted] 25X1

Monitoring Unfair Trade Practices

Hidden and visible subsidies, taxes, and other trade price distortions are inherent in the Chinese system, and many of these distortions will continue to exist, even with the decentralization of trade. Although the Chinese have used explicit taxes and subsidies basically to correct for misaligned domestic prices, these same mechanisms could also be used to give the Chinese an unfair trade advantage. At a minimum, the following types of information would be needed to monitor some of the more egregious methods the Chinese could use to violate the rules of fair trade. Even so, the continuation of a centrally administered price system will make it very difficult to evaluate the real costs of Chinese exports and the equivalent costs of producing importables; China will continue to be in a position of arguing that subsidies and taxes are needed to adjust for domestic distortions. [redacted] 25X1

Government Procurement Prices for Exportable Goods

Used in conjunction with world prices for equivalent goods, such data would help to establish whether the Chinese were selling below costs, assuming some correlation exists between procurement prices and real costs. Used in conjunction with domestic sales prices for the same goods, the data would help to identify those industries which are receiving government price supports. [redacted] 25X1

Wages and Other Costs of Production

Used in conjunction with information on labor productivity, wage data would help to determine whether the Chinese were selling exports below cost. However,

wage data will tend to understate true labor costs; Chinese wages are often subsidized both by the employing enterprise and the local, provincial, or central government through the provision of food and housing allowances. Hence, information on such subsidies would be useful. Information on non-labor costs of production such as energy and capital also would be helpful. 25X1

Direct Government Subsidies and Other Financial Incentives

Data are needed, by traded good, on the level of subsidies that are passed through the FTCs. In addition, for each industry information on direct government subsidies, concessional interest rates on loans, and favorable tax treatment would be useful in examining unfair trade practices. 25X1

Tariff Rates and Revenues for Imports

This information would be useful for assessing whether Chinese tariffs are in fact effective in influencing import decisions. A low level of revenues (relative to the tariff rate and the value of imports) might suggest that the Chinese tariffs are not being widely or consistently applied. 25X1

Domestic Sales Prices and Foreign Procurement Prices for Imports

These data would enable us to determine directly whether tariffs have been applied and hence provide a crosscheck for tariff data. Furthermore, such information would be useful for determining whether the central government is subsidizing the imports of export-oriented industries. 25X1

Share of Foreign Trade Conducted for Government-Run Enterprises

Data on FTC trade on behalf of other government-operated enterprises could be used to monitor Chinese progress in decentralizing foreign trade as well as to determine the incidence of government subsidies and tariffs. For each commodity, data would be needed on the shares of trade conducted by financially independent enterprises, by the FTCs on behalf of government-run enterprises, and by the independent trade arms of the various government ministries. 25X1

Prospects for Chinese Disclosure of Data

The Chinese have been willing to provide large amounts of financial data to the IMF as a condition of membership in that organization. Although the Chinese at first were reluctant to comply with the IMF's disclosure requirements, ultimately they agreed; the IMF's examinations of and prescriptions for their economy have been beneficial, for example, in helping them to reform the banking and financial sectors and to liberalize their foreign exchange regime. We anticipate that the Chinese initially will be reluctant to accept similar commitments to GATT for trade-related economic data. However, the Chinese probably could be persuaded, given the benefits of GATT membership; morever, they may find that a more transparent foreign trade system is in their benefit as well. 25X1